

TUCSON SUPPLEMENTAL RETIREMENT SYSTEM BOARD OF TRUSTEES

Meeting Minutes from Thursday, December 20, 2007, 8:30 a.m., 7th floor City Hall

- Members Present:** Brian Bjorndahl, Chairman
John Moore, City Manager's Appointee
Cindy Bezaury, Human Resources Director
Jim Cameron, Finance Director
John O'Hare, Employee Representative
Gage Andrews, Employee Representative
Paul Miner, Retiree Representative
- Staff Present:** Frank Kern, Board Counsel
Joe Ladenburg, Deputy Finance Director
Allan Bentkowski, Investment Manager
Michael Hermanson, Retirement Manager
Doris Rentschler, Finance Analyst
Claire Beaubien, Administrative Assistant
- Guests Present:** John Behrens, Finance Analyst, Investments
Suzanne Machain, Deputy Human Sources Director
Marie Nemerguth, City Manager's Office
Jean Wilkins, CTRA Retiree Representative
David Burns, CTRA Member
Kris Liberty, CTRA Member
Chuck Liberty, CTRA Member
Lois Rios, CTRA Member
Sharon McCuster, CTRA Member
Robert McCuster, CTRA Member
Elias Dominguez, CTRA Member
Ron Elias, CTRA Member
Jay Marks, CTRA Member
Ken Bolle, CTRA Member
Manny Romero, CTRA Member
Wayne Thureson, CTRA Member
Bill Robinson, COT Employee, Water
Glenn Weber, COT Employee, Water
Frances Ramirez, COT Employee, Water
Teri Smith, Julius Baer Investment Management

A. Call to order

Chairman Bjorndahl called the meeting to order at 8:30 a.m.

B. Consent Agenda

1. Approval of October 26, 2007 Board Meeting Minutes
2. Service & disability retirement ratification, and facts and figures report for November and December 2007
3. TSRS financial statements for September 30, 2007

Item B1: John O'Hare commented that he wanted to review the recording of the meeting to ensure all pertinent points were covered in the written minutes for item D2, page 7. John Moore **moved**, to approve the minutes, except for item D2 on page 7, seconded by Cindy Bezaury. **Motion passed, 7 to 0.** Items B 2, 3: John O'Hare **moved, seconded** by Gage Andrews, to approved items B2 and B3 as presented. **Motion passed 7 to 0.**

C. Julius Baer annual review – Teri Smith

Teri Smith presented Julius Baer's annual review. This firm manages an international core strategy; buying growth, value and emerging market stocks. Currently, up to 35% of the fund can be invested in emerging markets, which is an increase from the maximum 25% policy in March. No changes in staff have occurred during the year for Julius Baer.

The TSRS investment with Julius Baer posted a 27.17% inception to date return thru 11/30/07. As of December, the inception to date return was 14%, while the MSCI ACWI (ex-US) was up 12.8% and the MSCI EAFE index is up 8.1%. December was a volatile month for this fund. Julius Baer concentrates more on central and eastern Europe and India. Japanese continue to lag, so Julius Baer is underweight in Japan. Demographically, Japan has an aging population with a lower birthrate than most countries. In addition, Japan bans immigration created a smaller workforce as more Japanese are retiring.

Julius Baer is reluctant to invest very much in China because they do not have the financial reporting transparency there is with European companies. Central and Eastern Europe have been Julius Baer's favored places to invest, preferring financial institutions in those regions. The exception to this is the UK, which is underweight. Currently, the portfolio shows 4% that is invested in Indian companies. India has a strong domestic economy where approximately 60% of the domestic product is consumed within the country. The portfolio is underweight in Latin America due to the uncertain political and bureaucratic landscape. Mexico has been replaced by China as the world's manufacturer.

Julius Baer currently favors more countries in Western Europe. While Japan and China manufacture have cheap items to export, their consumers like purchasing expensive import goods; the more well-known the logo is, the more they pay for it. They also prefer expensive wines and spirits, which are mainly produced in Western Europe. Worldwide, materials like cement are another sector that is attractive because it is a heavy and expensive product to transport, and needs to be produced near the place where it will be used. And growth in infrastructure relies on materials such as cement. The portfolio owns several infrastructure investments such as the Frankfurt Airport. Energy sector exposure is primarily in Russia. While there are more risks in owning a Russian oil company, the payoff is generous. The average holding period of stocks in the portfolio amount to less than a year, and their turnover is about 90%.

D. Applications for Medical Retirement*

1. Karen Riggs

John O'Hare **moved, seconded** by John Moore, to approve the disability application for retirement. **Motion failed, 1 to 6.** Disability retirement denied.

E. Investment Activity / Status Report

1. Hewitt Prime Report for 9/30/07
2. Manager Allocations, compared with Policy Levels; CYTD Performance by Manager, FYTD, Performance by Manager
3. Securities Lending Income Summary
4. Update on Large Cap Growth Manager Transition

E1. Allan reviewed highlights of Hewitt's Performance Review and Investment Manager Evaluation (PRIME) report for 09/30/07. TCW Concentrated was terminated on 11/30/07 although their final returns outperformed the benchmark. Julius Baer performed exceedingly well. Causeway, however, has had some underperformance during previous months and has recently failed to meet performance criteria. The TSRS plan composite underperformed the custom index of 2.21% at 2.01 % versus the custom index at 2.21%. Calendar year to date, however, the plan composite returned 14.47% versus 15.04% for the custom index. The ten year return for the plan composite was 7.33% versus 7.89% for the custom index.

Allan reported that Hewitt indicated PIMCO's StocksPlus product on the watch list for the last quarter of '07 because of their three year performance. However, Hewitt's evaluation of StocksPlus is favorable overall. TCW

Value Opportunities was nearly put on the watch list and Causeway is nearly making the watch list. If either of these managers has another bad quarter, they will officially be on the watch list.

E2. Allan Bentkowski reported that October 10, 2007, saw the portfolio hit an all time record value of nearly \$715 million. Other values on October 22nd were \$695m, October 31st \$710m, November 30th \$697m and on December 19th, the fund dropped to \$686m. This volatility was driven mostly by the Equities.

Real Estate was in range; Allan pointed out that the JPMorgan Strategic Property is at or near the upper end of the target and will need to be rebalanced. After consulting with Hewitt, it was decided to place a withdrawal request for \$8 million which should be received around January 4, 2008. The available opportunities for investment have not been decided, but one possibility would be Friess, the new fund manager. Frank Kern commented that Friess had requested permission to exceed the investment policy limit of 10% to 15% for American Depository Receipts. Following consultations with Hewitt, Friess has been given permission to exceed the policy limit.

Calendar year-to-date returns for November were down, showing 8.2% versus 8.05% for the custom index. Fiscal year-to-date returns for overall performance was 1.57% versus 1.71% for the benchmark. PIMCO's fiscal year-to-date return was 8.0% versus the custom index of 4.28%. PIMCO expected the subprime problem and did well because of the change in the market environment. Total equities returned -1.34% versus -.64% benchmark. Real Estate fiscal year-to-date returns were 6.16% versus 7.06% for the NCREIF.

E3. Fiscal Year 2008, the fund has earned more than \$48,369 from securities lending and a total year-to-date custodial fees were \$105,616 thru October. The new large cap growth manager transition to Friess was completed on 12/12/07.

E4. TCW Concentrated Core was terminated on 11/30/07. Allan thanked Board Counsel Frank Kern for his help in making the transition go smoothly.

F. Amendments to 22-53 End of Service Incentive

Frank Kern recalled that the Board had previously approved the End of Service Incentive Program at the October, 2007 retreat. As approved by Mayor & Council, the ordinance for this program did not make the incentive available to entrants enrolled in the End of Service program on November 27th. A new consideration is being made to propose an amendment to Section 22-53 so that the incentive program can be extend to those who were in the End of Service program prior to the enabling date. Cindy Bezaury commented that this amendment is on TSRS agenda at the request of the City Manager and is favored by Mayor & Council as an issue of equal and fair consideration. Cindy asked Mike Hermanson for a snapshot view of the number of participants involved with this amendment. Mike reported there were 27 end of service participant signed up from the period of January through September 2007 and adding this amendment could cause the system to pay out as much as \$500,000 if everyone in the program converted their monthly accumulations to a "2 for 1" up to six months. The idea is that a person who has been in the End of Service program for six months or less, would work six months and get paid for an additional six months. A person who has been in the End of Service program for longer than six months would have a limited benefit, since they have met the six month maximum allowed in the program. For example, a person entering the End of Service program on June 1, 2007 would already have worked 7 months of their twelve at 12/31/07, leaving them five months to complete the End of Service program. The proposed amendment, states that person would only have to work an additional 2.5 months to received a 12 month EOS benefit. Both the original and the amended ordinance limit the maximum EOS benefit to 12 months.

John O'Hare asked Jim Cameron if the City was prepared to pick up the cost of the program. Jim replied that the City was already picking up the cost with the Employer contributions and there are no plans to change that commitment in the future. John commented that the City would be keeping these positions vacant without filling them since the current employees will be leaving six months early. This would save the City the cost of the salaries and fringes for that period. Bill Robinson asked why the new incentives would cost \$500,000 since the employee would be paid the amount regardless of whether they leave in six months or twelve months. Mike responded this is a worst case estimate to determine the amount of the incentive that could be paid out.

Frances Ramirez asked how the City could be saving any money by keeping people who signed up for the End of Service Program to begin August 1, 2007 through July, 2008 when they will be paying six months more of salary than if they allowed them to leave in February. Cindy replied that this Board is concerned only with what comes out of the pension fund whether the Board is willing to accept that responsibility. Mike commented that several people have various finance plans and it is apparent that some of those people would like to leave sooner with the incentive. Cindy commented that, in order to fill the vacant positions, each department has to look at their budget after the sick leave incentives have occurred to see if they can afford replacing the people who have left. It will not be clear how the budgets will look until after the incentive has ended and the number of participants is known. Cindy Bezaury **motioned, seconded** by Jim Cameron, to approve the End of Service Incentive modification to allow people not included in the previous incentive, to participate, with no participant receiving more than a 12 months pension benefits, and if the participant elects to participate in this new incentive, he will leave at the time they have accumulated 12 months of pension benefits but not later than September 30, 2008. John O'Hare commented that he voted for the incentive in 2006 because it was thought that the incentive would be neutral to the pension fund, which it proved not to be, so he would not be in favor of approving this incentive. **Motion approved 4 to 3** (John O'Hare, Paul Miner and Gage Andrews dissenting).

G. Study Group Report - Post Retirement Benefits - Discussion/Action

Jim Cameron introduced the members of the Post Retirement Benefits Study Group including Jean Wilkins, Suzanne Machain and John O'Hare. Jim remarked that the committee has worked on a draft policy proposal to establish a reserve fund for retiree benefits to be used for post retirement benefit increases. He then asked staff member Joe Ladenburg to continue discussion and overview the proposed policy. Conceptually, the policy proposes a benefit increase of the lesser of the annual change in the Consumer Price Index not to exceed 4%, measured for a 12 month period at June 30th each year, granted to retirees retired for 3 or more years. The granting of benefit increases would continue as long as funds are available in the reserve. Establishment of the reserve is based upon the existence of investment earnings in excess of the assumed actuarial rate (7.75%) measured on a 5 year rolling average basis. If such earnings exist, then transfers to this reserve continue as long as the TSRS actuarial funded ratio measured on a market value is at a minimum level of 80% (current funded ratio is 83.1% for FYE 6/30/07).

Further, the amount credited to this reserve will be based upon the earnings associated with the proportion of assets from the retiree reserve only, not on the entire assets of the TSRS fund. Earnings of the overall portfolio will be added to the post retirement benefit increase reserve based upon the proportion of that reserve account measured against all reserves in the fund at the end of the plan year. This proposed policy states the annual required contribution rate must be "less than it was when this policy is adopted" (current required funding rate for employer is 19.37% for FY 2008-9). The proposal states that amounts added to retiree benefits are considered to be permanent adjustments and shall be paid on a monthly basis, commencing on January 1 of each year.

Joe stated that this year's valuation report was used to calculate the excess as proposed, the breakdown is as follows:

Reserved for retirement benefits	\$378,595,694
Reserved for employee contributions	\$136,028,896
Reserved for employer contributions	\$181,350,484

for a total reserve of \$695,975,074. Using a 5 year rolling average investment return (per Hewitt) of 11.65%, the assumed return for actuarial purposes of 7.75%, there is a difference of 3.90%. So 3.9% of the retirement benefits reserve would be the amount transferred to the post retirement benefits reserve fund, resulting in an initial funded balance of \$14,765,243. These funds will come from the following sources in the following amounts:

Transfer from employee contributions	\$ 568,000
Transfer from employer contributions	\$14,197,243

John Moore asked Joe whether the 5 year rolling average investment return was correctly calculated, because it seemed high; one which we should certainly be proud of, but he needed to know how it was calculated. Joe

replied that this average was calculated by Hewitt. John commented that taking into consideration the bear markets of 2001, 2002, it is surprising that the average is 11.65%. Mike Hermanson asked how the committee selected a 5 year rolling average instead rather than the same 4 year smoothing used by the actuary in its actuarial assumptions. Joe replied that many options were discussed including a 10 year rolling average, and a using the single year actual market returns.

Mike asked if the rate of return falls to 6%, which is well below the actuarial rate of 7.75%, how would that factor into the rolling average in the upcoming 5 year roll? Joe replied that is based on a 5 year rolling average which would still be above the 7.75% actuarial rate. Gage asked when the total reserve amount of \$695,975,074 was calculated. He asked if the calculation was done after the returns of the previous year or were the returns already included in this amount of the three categories. He then asked if the returns from last year had been distributed, or is the City making additional distributions from these returns? Joe replied that all the numbers are based on the actuarial returns at June 30, 2007. Gage asked Joe if there had been a 10% return on investments then would the reserve for retirees increase by \$37 million based on the markets returns of that period or is it actuarially calculated. Mike remarked that the actuaries determine what the reserves need to be for the retiree and member reserves. Joe commented that he believes Gage's question is how the retiree reserve is calculated to be \$378 million. He said that rate is based on the 7.75% assumed return. The actuaries calculate the value of all the retiree liabilities that are currently out there (every year it is recalculated based upon future expected lives of members and beneficiaries). Joe said that the 7.75% is the rate used regardless of excess market returns or losses.

Cindy Bezaury expressed concerns over pulling funds from the employee contribution reserve when that reserve is money used to pay a non-vested employee's cashing out their retirement account on termination. That money needs to be there and should not be used for anything else, including additions to the post retirement benefit increase reserve. Joe replied that it doesn't matter where the money comes from but could be solved by having the actuary calculate two different rates. Cindy replied that was a good question for the actuary because she believes it does matter. If the employee is entitled to that money, that money can't be used for other purposes. Joe replied that when an employee takes a refund from their pension account, they get the full amount they contributed. Joe remarked that to the degree that the proposed policy will increase the contribution rate more than it would have been without the policy, the employees hired after 6/30/06 will pay a percent of that increased rate. Joe reiterated that there will be no impact on the post retirement benefits increase reserve should there be shortfalls in earnings. Any shortfalls or actual market losses will be born by the system which is funded by the City's contributions and new employees.

Cindy asked if there was a way to identify the earnings outside the reserves without taking into consideration the employee reserves or the retirants reserves. John Moore replied he wished there was because it really troubled him that the City and employees hired after 6/30/06 would bear any shortfalls versus the assumed rate of return. Mike commented that is pretty standard throughout the industry that the employer bears any shortfalls. Gage asked for clarification of how the new reserve would work. He asked if there will be a new reserve entitled post retirement benefit increase reserve that will be earmarked for post retirement benefit increases? He asked if the monies are earmarked for the post retirement benefit increases are they then moved into another reserve so that it is even more allocated. Doris replied that once the monies are moved into the reserve, those monies are used exclusively for that purpose. Once the increases are in effect, those monies are then moved into the retirant reserve to be posted to their accounts. Mike asked if there was going to be interest added to this reserve. Joe replied that any balance in the reserve would earn at the actual annual return of the fund.

Frank Kern commented that the policy draft states that the Post Retirement Benefits Increase (PRBI) Reserve Fund shall receive investment earnings in excess of the actuarially assumed rate of return (currently 7.75%) contingent on a minimum funded ratio initially of 80%. He asked if the minimum funded ratio falls to 78% would a PRBI be granted. The verbiage of the proposed policy says that the earnings would not be TRANSFERRED to the reserve but a PRBI could be paid as long as there were funds remaining in the account. He then summarized the policy to state that PRBI could be paid to retirees as long as there are funds available in the reserve. Frank asked if the operation of this separate account cause a problem with the fund's funding ratio. John O'Hare asked Joe what was the expected cost for a 2% PRBI. Joe replied that based on an average increase of 1.43% the last ad hoc, the total liability increase was approximately \$3.5 million. John remarked that using that figure of \$3.5 million, a 4% increase would have an actuarial cost of approximately \$9 million. Gage

asked if the 80% funded ratio was before funding the reserve or after funding the reserve. Frank commented that his impression was that the 80% funded ratio had to be maintained before a PRBI could be paid but the draft policy was not clear on that issue. Jim Cameron remarked that the intent was that the transfer could not cause the funded ratio to fall below 80%.

Cindy commented that paying the benefit (by transferring these earnings) would affect the unfunded liability which would drive the funded ratio down below the 80%. Frank pointed out that the verbiage "it shall constitute a permanent adjustment to such pension benefits" would cause an unfunded liability. Mike commented that down the road it would likely compound considering the demographics and the future investment earnings that drives these things. Paul Miner complimented the study group on what they brought to the Board. He commented that the retirees have received increases for the past seven years. He said that everything discussed by the board today was done on an ad hoc basis in the past seven years, whether it was a good idea or not. What the committee has done is come up with a program with guidelines that shares earnings that occurred. The Board has never had any guidelines before. The committee is making sure the fund is sound.

Gage Andrews commented that he concurred with Paul's remarks. He said his biggest frustration was trying to figure out what is an appropriate way to make an ad hoc decision. He said that this issue is incredibly complicated as verified by the study group. He said it is extremely difficult to evaluate the financial effects of the decision on the fund, on the retirees, and on the Board. He said he still doesn't understand the issue fully and admires the people who have spent 2-1/2 years on the study committee doing just that. Chairman Bjorndahl concurred with Gage. He said he was comfortable with the ad hoc increases because the actuary would give advice whether it was ok to grant the increases or not. He said he needed more time and information before he can make a decision. John Moore complimented this Board past history of decision making, always thinking long-term, and observed that the system has reaped dividends from that conservatism; such as the funded ratio has been trending upward at 83.1%, contribution rates have been heading south, our advisors have steered us into some good fund managers producing excellent returns; the assumed earnings rate was moved to 7.75% based on the last experience study, and many other positive things have been done that are putting this system on very solid ground financially.

Mike suggested that perhaps the board would consider scheduling a special meeting and have Gabriel Roeder and perhaps Hewitt available for the discussion.

Gage Andrews **moved, seconded** by Cindy Bezaury to hold a special meeting, including Gabriel Roeder and Hewitt, if possible, devoted just to this issue. **Motion passed 7 to 0.**

H. Annual income review for Disability Pension Benefits – Discussion/Action

Mike reminded the Board that the Retirement Office conducts an annual income audit of the Disability Retirement recipients to ensure that the combination of their pension benefits, social security benefits, workmen's compensation or other income do not exceed 80% of their average final monthly compensation while they were with the City. If a participant does exceed 80% of the average final monthly compensation, the retirement office reduces the participant's benefit to make the combination 80%. One of the recipients who have been audited for several years is Richard Hilbert who obtained a position working in a call center making a good income. This position caused the retirement office to eliminate his pension benefit in 2006 and 2007 because he exceeded the 80% requirement. Mr. Hilbert sent a letter informing the retirement office that he would receive his final paycheck in December, 2007. His only source of income after that would be his social security benefit since his pension benefit had already been terminated and would not be reinstated until after the disability audit in 2009 because the audit in 2008 would be based on income for 2007. Mike requested that the retirement office could verify that this retiree truly does not have other income except for social security. Mike would like to put a mechanism in place to be able to verify situations such as this since it is likely that this situation will happen in the future with other disability retirees. John Moore asked if it was possible to have the retiree sign affidavits asserting that he has no other income source. There would be recourse once the tax records are received for the annual audit. Cindy commented that she needed to know whether he is truly disabled per his original disability application. Cindy Bezaury **moved, seconded** by Paul Miner, to give staff the authority to move forward with establishing a procedure to verify a disability retiree's lack of income and continued medical disability. **Motion passed 6 to 0, 1 abstention.**

I. Future Agenda Items – (2008 Board Meeting Schedule)

Special Board Meeting to discuss the Post Retirement Benefit Increase.

J. Call to Audience

John O'Hare commented that Mike Hermanson and Staff did a great job in their presentation to the Water Department regarding the End of Service Program.

K. Adjournment

John O'Hare **motioned, seconded** by Gage Andrews, to adjourn the meeting. **Motion passed 7 to 0.** Meeting adjourned 11:36 a.m.

Approved:

Brian Bjorndahl, Chairman Date

Michael Hermanson, Date
Retirement Manager